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UNCLAS E F T O SECTION 01 OF 05 OTTAWA 000640

SIPDIS

SENSITIVE

DEPARTMENT FOR EB/IFD, EB/OMA, WHA/EPSC, AND WHA/CAN
STATE PASS FEDERAL RESERVE BANK FOR CHUGH
STATE PASS SEC FOR JACOBS
TREASURY FOR WILBUR MONROE AND DAVID NAGOSKI
PARIS ALSO FOR USOECD

E.O. 12958: N/A
TAGS: EFIN ECON PGOV CA
SUBJECT: CANADA'S 2005 BUDGET: SOMETHING FOR EVERYONE

REF: A. OTTAWA 594 (BUDGET POLITICS)
¶B. OTTAWA 375 (BUDGET PREVIEW)
¶C. 04 OTTAWA 2779 (SURPLUS)
¶D. 04 OTTAWA 2837 (EQUALIZATION)
¶E. 04 OTTAWA 2560 (HEALTH CARE SUMMIT)
¶F. 04 OTTAWA 832 (2004 BUDGET)

¶1. Sensitive but unclassified. Not for Internet or distribution outside the USG.

¶2. (U) Introduction and Summary: Canada's Opposition parties were hard-pressed to complain about the minority Liberal Party's February 23 budget. Prime Minister Paul Martin and Finance Minister Ralph Goodale listened to Canadians, and tabled a smorgasbord that funds Liberal campaign promises, appeases Conservatives with tax cuts and increases in defense spending, and provides a nod to the Left with funding for the environment and social programs (refs A and B). This budget takes a five-year, rather than the previous years' two-year, outlook and continues the GOC's commitment to "balanced budgets or better." The hefty budget drew criticism from some for its lack of focus, its skimpy funding for many programs, and for back-loading most spending and tax cuts until after 2007. It is expected to be approved by Parliament the week of March 7.

¶3. (U) With fiscal impact next year (2005-06) of C$7.4 billion (US$6 billion), new initiatives in Canada's eighth consecutive balanced budget total C$75.7 billion (US$60 billion) through 2010, with relatively little spending in the first two "skinny" years and most spending in the out years (2008-10). The Liberal party campaigned on promises to boost spending on health care (ref E), to revise equalization payments for the provinces (ref D), and to support cities, a national childcare program, and senior citizens. This budget funds those priorities while adopting attractive initiatives from the Opposition parties. The budget previews the long-awaited (and long delayed) International Policy Statement by providing additional money for foreign affairs, steep increases in defense spending (someday), and continuing the commitment to increase aid budgets by 8% a year.

¶4. (U) Although markets were largely unmoved (pre-budget leaks were, on the whole, accurate), analysts attribute the Canadian dollar's brief post-budget fainting spell to the announcement that the 30% foreign content ceiling on tax-advantaged retirement investments would be abolished. Details of spending follow in paragraph 8. End introduction and summary.

Notes:
-- Canada's fiscal year runs from April 1-March 31.
-- Canadian dollar amounts are converted at the exchange rate of about C$0.80/US$1.
-- The budget documents are available at the Department of Finance website: www.fin.gc.ca/finsearch/wn e.asp.

Assumptions

¶5. (U) Using a consensus of private-sector forecasts, the budget assumes that Canada's economy will grow 2.9% in 2005 (slightly lower than previous forecasts), at 3.2% in 2006, and at an average of 2.9% for 2007-2009. Growth slowed towards the end of 2004, and expectations for economic growth in 2005 have been revised downward as the impact of Canadian dollar appreciation is re-assessed. The budget is based on the assumption that in the near term the GOC will not enjoy revenue flows that created larger-than-anticipated surpluses in recent years.

-- Commodity prices will remain strong, providing continuing support to the Canadian dollar.

Fiscal Projections

¶6. (U) Measures proposed since the last budget (ref F) have

a fiscal impact of C$10.9 billion (US$8.7 billion) in 2004-05 and C$7.4 billion (US$6.9 billion) in 2005-06. In addition to the measures announced on February 23, these figures include federal commitments made later in 2004 to fund healthcare (ref E), revise the equalization framework (ref D), and support those affected by the impact of discovery of cases of BSE (bovine spongiform encephalopathy) in Canada. After a surge in spending this fiscal year, the GOC projects two "skinny" years before spending increases after 2007. Tax cuts are either phased in gradually (as with elimination of the tax on jewelry) or take effect starting in 2007 or 2008. Total net cost of budget initiatives proposed since March 2004:

Fiscal Year	C$ billions	US$ billion
2004-05	10.9	8.7
2005-06	7.4	6.9
2006-07	8.8	7.0
2007-08	11.1	8.9
2008-09	16.3	13.0
2009-10	21.2	17.0
Total net cost	75.7	60.6

¶7. (U) This budget continues the GOC's decade-long commitment to debt reduction. The unexpectedly large surplus in 2004, added to the usual annual C$3 billion set aside for debt reduction, mean Canada's debt/GDP ratio continues to decline, reaching 38.6% in 2004-05. The federal debt/GDP ratio is on target to reach 30.6% by 2009-10 (down from 68.4% in 1995 and with a goal of reaching 25% in 2015). This budget maintains the traditional C$3 billion contingency reserve and an additional cushion for "economic prudence." If not needed during the year, the contingency reserve is dedicated to reducing the federal debt. The allocation for economic prudence increases from C$1 billion (US$800 million) next year to C$2 billion (US$1.6 billion) in 2006-07 and C$4 billion (US$3.2 billion) in 2009-10, reflecting the increased uncertainty in longer-term projections.

-- Program expenses: Federal program spending as a share of GDP is expected to increase 0.6% to 12.2% in 2004-05 due to one-time commitments to the provinces made last year. Program expenses in 2005-06 are expected to increase only 2%, due to the impact of the one-time measures in 2004-05 that boosted spending by 11.9%. Growth in program expenses in 2006-07 and 2007-08 is expected to be about 5%. In the last two years of the budget horizon the GOC anticipates growth in program spending of about 4.5%. Overall, program spending increases 23% through 2009-10, to C$194.5 billion (US$155.6 billion) from the current C$158.1 billion (126.5 billion).

-- Surplus: This year's surplus is expected to exceed last year's C$9 billion (US$7 billion) windfall (ref C) but the GOC projects declining surpluses in the next two years (2006-07 and 2007-08). Current forecasts show increasing surpluses after 2008 as economic growth picks up. (Note: The surplus in 2004 and 2005 has benefited from unexpectedly strong growth in tax revenue. Corporate tax revenues in 2004 increased 16.6% in 2004 and profits are strong this year. Revenue from personal taxes grew by 5.8% in 2004. End note.) The GOC budget addresses that by front-loading some spending commitments to 2004-05 and postponing others. Over C$11 billion (nearly US$9 billion) committed to the provinces for healthcare and equalization payments in 2004-05 are pending Senate passage and royal assent, but are expected to be booked by the March 31 end of this fiscal year.

-- Expenditure review: Upon taking office in December 2003, Prime Minister Martin called for expenditure review by all departments and agencies, with the objective of identifying C$12 billion in low-priority spending that could be reallocated (refs C and F). This budget reflects the result, with C$11 billion (almost US$9 billion) in cost cutting. Minister Goodale emphasized in his budget speech that expenditure review will be an ongoing feature of government operations. Changes include standardizing procurement, upgrading technology for check processing, reducing the space and cost of furnishings allocated to federal employees, and improved property management. About 10% of the savings comes from actually eliminating programs.

-- Provincial governments: The GOC has agreed to C$41.3 billion (US$33 billion) over 10 years in new health care funding (ref E) and an increase of C$33.4 billion (US$26.7 billion) over 10 years for a new framework for "equalization" payments from rich to poor provinces (ref D). The consolidated provincial-territorial budgets are expected to return to surplus this year after two years of deficit, with combined federal, provincial and municipal surpluses of C$17 billion (US$13.6 billion). The provincial-territorial debt/GDP ratio declines to 22.3% in 2004-05, well below the federal level. The recent deals with the provinces have focused attention on the ways in which the federal government distributes revenues, with Ontario (a net donor province) calling for more federal money.

Specific Programs: a little for everyone

-- Diplomacy and International Relations

¶8. (SBU) This budget provides an encouraging preview of the likely direction of the GOC's long-delayed International Policy Statement. The Department of Foreign Affairs receives a significant boost:

o C$42 million (US$33.6 million; "what we hoped for" according to a policy expert at Foreign Affairs) to increase the number of diplomats abroad. (Canada severely cut back its overseas presence in the 1990s due to budget constraints.)

o C$59 million (US$47 million) to boost security at foreign missions.

o C$500 million (US$400 million) over five years for new a "Peace and Security Fund" controlled by the Department of Foreign Affairs. (Comment: Although this money is part of the foreign assistance envelope, it will be used to fund foreign policy initiatives such as capacity building for counter-terrorism and African peacekeeping; police training (Iraq and Haiti); the Global Partnership with Russia to dismantle nuclear weapons, and other similar projects. End comment.)

-- Defense

¶9. (SBU) The C$12.8 billion (US$10.2 billion) headline figure in additional spending for defense is the largest in 20 years, although most spending will be after 2008 and much is for previously-announced projects. Spending increases in 2005-06 (C$500 million/US$400 million) and 2006-07 (C$600 million/US$480 million) are actually smaller than in past years. By 2009, it is anticipated that the defense budget will include additional spending of C$5.7 billion (US$4.6 billion) a year. (Note: Officials at Finance explained that once these spending increases are implemented, the reference level for future defense spending will be over 20% higher. End note.) Provisions include:

o C$3 billion (US$2.4 billion) over five years to increase the number of active duty troops by 5,000 and reservists by 3,000 and C$3.2 billion (US$2.6 billion) for sustaining operations.

o C$2.8 billion (US$2.2 billion) to fund equipment purchases such as transport helicopters, aircraft, and support for the special forces teams and C$3.8 billion (US$3 billion) to fund the "new defense policy." None of those funds will be allocated until 2007.

-- Foreign Assistance

¶10. (U) The foreign assistance envelope increases by C$3.4 billion (US$2.7 billion) over five years, continuing the commitment to increase foreign aid by 8% a year through 2010 and double aid to Africa from 2003 levels. As with defense, most of the increased aid spending will come after 2006, with only C$100 million (US$80 million) of the increase in FY2005-06. This also signals the start of Canada's new policy of reducing the number of its recipient countries to target those that can make best use of assistance. The GOC says that Canada's generous tsunami response boosted Canada's ratio of aid to GDP to 0.3% (from 0.25%), and the new money will allow it to maintain the 0.3% level.

-- Security
¶11. (U) C$1 billion (US$800 million) over five years is allocated for security, including:
o C$222 million (US$178 million) for marine security (patrol vessels in the Great Lakes and port patrols).

o C$433 million (US$346 million) for U.S.-Canada border security. (Comment: This funding is new, and hasn't yet been allocated. End comment.)

-- Environment

¶12. (U) Environmental programs are considered "winners," with C$5 billion (US$4 billion) in funding, of which C$3 billion is new, scattered through a range of programs. Canada is a Kyoto Accord signatory, and is feeling public pressure to start addressing emissions targets. About half the spending provides incentives to reduce greenhouse gases, including:

o C$1 billion (US$800 million) for a "Clean Fund" to stimulate reduction in greenhouse gases.

o C$225 million (US$180 million) over five years to subsidize energy-efficient retrofitting of homes.

o C$200 million (US$176 million) over five years (and C$920

million over 15 years) to encourage installation of wind power turbines;

o C$295 million (US$236 million) over five years to accelerate the write-off of business spending on energy efficient technology.

o C$85 million (US$68 million) over five years to combat invasive species in the Great Lakes and

o C$209 million (US$167 million) over five years to improve the infrastructure in national parks.

-- Taxes and Finance

¶13. (SBU) Businesses received a cumulative C$4.9 billion (US$4 billion) in tax breaks, but they are either phased in very gradually (such as elimination of the tax on jewelry) or take effect after 2007. One of the most notable is the reduction in the corporate income tax rate to 19% from 21% by ¶2010. Capital cost allowance rates will also be better aligned with the life of the assets. (Note: We are told that tax cuts will not be a high priority going forward. The magnitude of corporate tax cuts probably won't change, but implementation may be advanced. It would be hard to take further action on corporate taxes without matching efforts on personal taxes. End note.) Tax provisions include:

o Increasing the basic personal tax exemption to C$10,000 (US$8,000) over five years (from C$6,500 now).

o Increasing the contribution limits for tax-advantaged retirement accounts to C$22,000 in 2010, from C$18,000 in ¶2006.

o Increasing tax benefits for those caring for disabled dependents or adopting a child.

-- Financial sector

¶14. (U) There was reiteration of federal support (non-financial) for "an enhanced system of securities regulation," and the GOC plans to convene a meeting with the provinces to work on the issue.

-- There was no mention in the budget of a long-awaited decision on bank mergers.

-- The budget launched a review of financial institutions legislation, seeking to "refine the current framework to increase legislative and regulatory efficiency." The review should result in legislation in 2006.

-- A provision removing the 30% limit on foreign content in tax-advantaged retirement plans received widespread attention. Analysts attribute the Canadian dollar's brief post-budget fainting spell to this measure);

Everybody's paid, but not everybody's happy

¶15. (SBU) A GOC fiscal expert describes the budget as a "qualified success." The Liberals handily avoided a no-confidence vote, but have been criticized for lack of focus, skimpy funding for many programs, and for back-loading the spending and the tax cuts. Several analysts commented on the switch to a five-year horizon, despite Paul Martin's repeated opposition to long-term budgeting while he was finance minister. The explanation is straight-forward: revenues in the coming two "skinny years" are inadequate to fund campaign promises and an increasing number of initiatives have a five-year (or longer) implementation strategy. Finance officials say "we would have been killed" had the budget only addressed funding for the next two years. The five-year time frame was praised by private-sector forecasters (and was recommended by the IMF and others) but, given that most spending was deferred to the out-years, drew some cynical response that this government is making promises it may not be around to fulfill. There has also been criticism that for a government preaching "fiscal prudence," this much spending is only possible due to surpluses resulting from over-taxing Canadians.

¶16. (SBU) Some of the strongest opposition came from officials of the Ontario Liberal Party (not to be confused with the federal Liberals). Premier Dalton McGuinty is outspoken about the fact that Ontario provides 40% of federal government revenues but receives C$23 billion a year less than it provides due to the "equalization payments" to fund health care and other provincial services. As the central government revises the equalization framework to provide more goodies to Quebec, the Atlantic provinces, the west and various interest groups (ref D), Ontario, one of the three "donor" provinces, is starting to demand more attention.

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